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# Supreme Court of the United States

DEPARTMENT OF THE REVENUE
OF THE COMMONWEALTH OF KENTUCKY, AND
FINANCE AND ADMINISTRATION CABINET OF THE
COMMONWEALTH OF KENTUCKY, ET AL.,
*Petitioners,*

v.

GEORGE W. DAVIS AND KATHERINE V. DAVIS,
*Respondents.*

**On Writ of Certiorari to**
**the Court of Appeals of Kentucky**

## BRIEF OF MULTISTATE TAX COMMISSION AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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## BRIEF OF MULTISTATE TAX COMMISSION as *AMICUS CURIAE* IN SUPPORT OF PETITIONERS[1]

## INTEREST OF AMICUS CURIAE

*Amicus Curiae* Multistate Tax Commission (Commission) files this brief in support of the Commonwealth of Kentucky. The Commission agrees with the Commonwealth that its tax treatment of bond interest income earned by its residents is not "discriminatory" for purposes of the dormant Commerce Clause.

The Commission is the administrative agency for the Multistate Tax Compact (Compact), which became effective in 1967. *See* RIA ALL STATES TAX GUIDE ¶ 701 *et seq.*, (2005). Today, forty-seven states and the District of Columbia are members of the Commission. Twenty have legislatively established full membership. Seven are sovereignty members and twenty-one are associate members.[2] This Court

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[1] No counsel for any party authored this brief in whole or in part. Only *Amicus* Multistate Tax Commission and its member states through the payment of their membership fees made any monetary contribution to the preparation or submission of this brief. This brief is filed by the Commission, not on behalf of any particular member state. Finally, this brief is filed pursuant to the consent of the parties.

[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The purposes of the Compact are to: (1) facilitate proper determination of State and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation. *See* Compact, Art. I. These purposes are central to the very existence of the Compact, which was the states' answer to an urgent need for reform in state taxation of interstate commerce. *See e.g.*, H.R. Rep. No. 952, 89th Cong. 1st Sess., Pt. VI, at 1143 (1965). Substantial lack of uniformity had resulted in burdensome complexity and uncertainty, and in an elevated risk of duplicate taxation or less than full apportionment of income. If the states failed to act, Congress stood ready to impose reform itself through federal legislation that would preempt and regulate state taxation.[3]

The promise of increased uniformity established by the states' adoption of the Compact was critical to preserving the recognized sovereignty the states enjoyed, and continue to enjoy, with respect to taxation of interstate commerce. Preserving state tax sovereignty under our vibrant federalism remains a key purpose of the Commission. The importance

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[3] The Willis Committee, a congressional study of state taxation mandated by TITLE II OF PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. *See generally Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966).

the Commission attaches to the present case, and our motivation for filing this brief today, lies in this goal of preserving states' authority to determine their own tax policies within federal constitutional and statutory law, and in protecting that authority from a needlessly expansive interpretation of federal limitations. The Commission agrees with the Commonwealth of Kentucky that its treatment of bond interest income earned by its residents does not discriminate against interstate commerce; and that the expansive interpretation of the dormant Commerce Clause suggested by respondents would result in harmful and pointless pre-emption of the Commonwealth's and approximately 40 other states' lawful tax structures.

## SUMMARY OF ARGUMENT

A state tax structure discriminates against interstate commerce in violation of the dormant Commerce Clause if it favors in-state private business interests and thereby impedes free trade in competitive national markets. Because the state tax structure at issue in this case favors the state itself in providing public services, which are not supplied in competitive national markets, and treats all private business interests the same, it does not discriminate against interstate commerce. There is no rationale for expanding the reach of the dormant Commerce Clause to prohibit differential tax treatment of state governments in addition to private business interests. State governments are sovereigns, for which the whole notion of competition, and the very concern of the Commerce Clause, does not apply. Competition would not be served by eliminating a tax differential as between States, and the dormant Commerce Clause has no job to do.

A nondiscriminatory state regulatory structure may be sustained where any unavoidable burdens it imposes on interstate commerce are outweighed by its benefits to the state.

Assuming *arguendo* a balancing of burdens and benefits also applies in the area of state taxation, a state's tax exemption for interest paid on its bonds should be sustained because it does not burden interstate commerce. There is no burden because the state government services supported with the bond proceeds are provided within the discrete boundaries of the state and not in competition with the public services of other states. Furthermore, the state and its residents receive substantial benefits from the tax exemption, in that the exemption encourages state residents who benefit from the services to defray the costs of those services by purchasing State bonds. The state also benefits because the tax exemption reduces the burden of administering a taxable bond program that would require the state to pay a higher interest rate on the bonds, with no net benefit either to the state or to the resident bond purchasers.

## ARGUMENT

### I. A STATE TAX STRUCTURE THAT FAVORS THE STATE ITSELF, BUT TREATS EVERY OTHER PUBLIC AND PRIVATE ENTITY THE SAME, DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE FOR PURPOSES OF THE DORMANT COMMERCE CLAUSE.

The 10th Amendment of the U.S. Constitution grants the federal government power to regulate only those matters specifically delegated to it. Other powers are reserved to the states, or to the people. One such federal delegation is contained in the Commerce Clause, which reserves for Congress the exclusive power "... [t]o regulate Commerce with foreign Nations, and among the several States." U.S. CONST. art. I, §8, cl. 3. This explicit delegation has long been held to contain a negative inference, restricting State authority even in the absence of an explicit federal regulation if the state action

would improperly discriminate against or burden interstate commerce. See, *e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-313 (1992).

The question presented is whether a state tax structure discriminates against or burdens interstate commerce when it exempts the interest income earned by its residents on its own state and political subdivision bonds but taxes the interest income earned by its residents on other states' bonds.[4] The answer is "no" for the reasons set forth below.

### A. A State Tax Structure Discriminates Against Interstate Commerce if it Favors In-State Private Interests Competing in National Markets.

The dormant Commerce Clause does not blindly prohibit every differential in state taxation. To be of concern, a differential must be relevant to the purposes of the Commerce Clause itself. The purposes of the Commerce Clause, from which the purposes of the dormant Commerce Clause flow, were explained by this Court in *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525 (1949):

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. *Such was the vision of*

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[4] KY. REV. STAT. ANN. §141.020(4)(2006)

> *the Founders; such has been the doctrine of this Court which has given it reality.*

336 U.S. 525, 539 (emphasis added)

Thus, the dormant Commerce Clause has been held to prohibit state taxes that discriminate against interstate commerce; where "interstate commerce" involves a national market place, and "discrimination" involves differential treatment of the private business interests competing in that market place. See, e.g., *Reeves, Inc. v. Stake*, 447 U.S 429, 437 (1980) (prohibiting a differential treatment that discriminates against interstate commerce thereby "imped[ing] free private trade in the national market place"); *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273-274 (1988) ("[The] 'negative' aspect of the Commerce Clause prohibits economic protectionism – that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors" (citations omitted); *General Motors v. Roger W. Tracy, Tax Commissioner of Ohio*, 519 U.S. 278, 299 (1997) (referring to "...the dormant Commerce Clause's fundamental objective of preserving national markets for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors"); *In re Trade-Mark Cases*, 100 U.S. 82, 96 (1879) (For Commerce Clause purposes, "...commerce among the States means commerce between the individual citizens of different States...").

### B. A State Tax Structure That Favors the State Itself Does Not Discriminate Against Interstate Commerce Because It Does Not Favor In-State Private Interests Competing in National Markets.

The beneficiary of the tax structure at issue in this case is the state itself, not in-state private businesses competing in a national market. As such, the tax structure does not discriminate against interstate commerce for purposes of the dormant Commerce Clause.

This Court recently considered the application of the dormant Commerce Clause in a similar case. In *United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority* 550 U.S. ___, 127 S. Ct. 1786, 167 L.Ed.2d 655 (2007), two county governments adopted an ordinance requiring all waste haulers operating within their jurisdictions to utilize and pay tipping fees to the Counties' own waste processing facility. The Court noted "[t]he flow control ordinances ...benefit a clearly public facility, while treating all private companies exactly the same." *United Haulers*, 127 S.Ct. 1786, 1795. As such, the ordinances did not discriminate against interstate commerce.

The situation in the present case is analogous. Here, the State's issuance and tax treatment of its bonds benefit clearly public facilities. As explained by the National Association of State Treasurers in its brief as *amicus curiae* in support of petitioners on the Petition for Certiorari:

> State and local governments issue municipal bonds to raise funds to support general government needs or to fund public works projects and programs. Governments fund a wide range of capital projects through municipal bonds, including educational buildings at all levels from elementary schools to colleges and universities, government buildings, transportation facilities (including bridges, highways, and airports), public utility projects, hospitals, stadiums, and low income housing.

National Association of State Treasurers, Brief as *Amicus Curiae* in Support of Petitioners on Pet. for Cert. at 5

In *United Haulers*, the "ordinances [gave] the Counties a convenient and effective way to finance their integrated package of waste disposal services." 127 S. Ct. 1786, 1798 (Roberts, C.J.). Likewise in this case, Kentucky's issuance and tax treatment of its bonds give the Commonwealth a convenient and effective way to finance multitudes of government facilities supporting many state government services.

The direct beneficiary of this tax structure is the state itself, and ultimately the recipients of the state's services, not a particular class of in-state private businesses competing in a national market. Indeed, the bond interest income of all private entities is taxed exactly the same.

Thus, like the *United Haulers* case, this case does not implicate prior dormant Commerce Clause jurisprudence invalidating State tax and regulatory measures that discriminate in favor of in-state private business interests competing in a national market. See e.g., *Boston Stock Exchange v. State Tax Comm.* 429 U.S. 318 (1977); *C&A Carbone, Inc. v. Town of Clarkstown* 511 U.S. 383, 416 (1993) (Souter, J. dissenting) ("The outstanding feature of the statutes reviewed in the local processing cases is their distinction between two classes of private economic actors...").

In *United Haulers*, the Court recognized "[c]ompelling reasons justify treating these laws [favoring the County governments in their provision of government services] differently from laws favoring particular private businesses over their competitors." *United Haulers*, 127 S. Ct. 1786, 1795. Were the state's tax differential structured to exempt interest income earned by its residents on bonds issued by, for exam-

ple, in-state car manufacturers, while taxing the interest income earned by its residents on bonds issued by out-of-state car manufacturers, there could be discrimination against interstate commerce. But here, where the beneficiary of the tax differential is the state itself in its provision of government services, there is no differentiation between in-state and out-of-state business interests engaged in a competitive national market, and thus no discrimination against interstate commerce.

### C. There is No Rationale for Expanding the Dormant Commerce Clause to Prohibit Differential Tax Treatment of State Governments in Addition to Private Interests.

States do not compete among themselves to supply state government services in a national market. Rather, each state is the exclusive provider of state government services within its own geographic borders. Because state government services are not supplied in a competitive national market, a state tax structure that benefits the state itself relative to the other states in the provision of such services does not discriminate against interstate commerce in any way that is relevant to the dormant Commerce Clause.

In *General Motors v. Tracy*, 519 U.S. 278 (1997), this Court considered a state sales tax exemption that applied to natural gas sales made by rate-regulated public utilities but not to natural gas sales made by unregulated natural gas marketers. The Court found the entities did not actually compete and considered the application of the dormant Commerce Clause:

> Conceptually, of course, any notion of discrimination assumes a comparison of substantially similar entities. ... [W]hen the allegedly competing enti-

> ties provide different products, ... there is a threshold question of whether the companies are indeed similarly situated for constitutional purposes. This is so for the simple reason that the difference in products may mean that the different entities serve different markets, and would continue to do so even if the supposedly discriminatory burden were removed. If in fact that should be the case, eliminating the tax or other regulatory differential would not serve the dormant Commerce Clause's fundamental objective of preserving a national market for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors. ...[I]n the absence of actual or prospective competition between the supposedly favored and disfavored entities in a single market there can be no local preference, whether by express discrimination against interstate commerce or undue burden upon it, to which the dormant Commerce Clause may apply. *The dormant Commerce Clause protects markets and participants in markets; not taxpayers as such.*

519 U.S 278, 298-300 (emphasis added)

Each state provides its government services in its own, geographically distinct jurisdiction. There is no actual or prospective competition among the favored state and other states in a "market" for state government services. The consumers of state government services will be served by the state in which they reside, are domiciled, or are doing business; regardless of preferential tax treatment for that state's financing of its government services. Thus, the favored state and another state can never be similarly situated for constitutional purposes. Two states cannot similarly offer government ser-

vices in one jurisdiction. State governments are sovereigns, for which the whole notion of competition, and the very concerns of the Commerce Clause, do not apply. So far as financing for government services is concerned, "competition would not be served by eliminating any tax differential as between [states], and the dormant Commerce Clause has no job to do." *General Motors v. Tracy*, 519 U.S. 278, 303.

## II. A STATE TAX STRUCTURE THAT FAVORS THE STATE ITSELF, BUT TREATS EVERY OTHER PUBLIC AND PRIVATE ENTITY THE SAME, DOES NOT IMPOSE A BURDEN ON INTERSTATE COMMERCE IN EXCESS OF ITS LOCAL BENEFITS.

Assuming *arguendo* that *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) applies to a state tax structure, a nondiscriminatory statute will withstand a dormant Commerce Clause challenge under *Pike* "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." 397 U.S. 137, 142.[5]

### A. A State Tax Structure That Favors the State Itself in Providing Government Services Does Not Burden Interstate Commerce.

First, Kentucky's financing program for government facilities used in the provision of its state government services imposes no discernible burden whatsoever on interstate commerce, because as explained above, there is no competitive national market for state government services.

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[5] Petitioners present a compelling argument that Pike is inapplicable in a dormant Commerce Clause challenge to a state tax statute. Brief of Petitioners, at n. 16.

Respondents seek to require that Kentucky subsidize the costs of bond financing in other states, even though neither the Commonwealth of Kentucky nor its residents - including the respondents – benefit from the services provided as a result of that financing. Nothing in this Court's Commerce Clause jurisprudence requires a state to subsidize the costs of a noncompetitive market that is available wholly outside of that State. *cf., General Motors v. Tracy*, 519 U.S. 278, 298-302 (tax exemption for sales by publicly owned utilities but not for sales by private utilities does not discriminate against out-of-state private utilities under Commerce Clause, because public and private utilities serve distinct, noncompetitive markets).

Next, the economic effects of Kentucky's limitation of its income tax exemption to bonds issued by the Commonwealth or its subdivisions are limited to the Commonwealth of Kentucky. Only Kentucky residents who purchase the bonds of other states or their subdivisions are affected by the denial of the tax exemption. Nonresidents that are subject to Kentucky income tax are not taxed on income from sources outside Kentucky. KY. REV. STAT. ANN. §141.020(4)(2006). The same is true in any state that limits the income tax exemption to bonds issued by itself or its subdivisions because a state may not constitutionally tax nonresidents on income derived from sources outside the taxing state. *Shaffer v. Carter*, 252 U.S. 37 (1920); *Travis v. Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920). While a state statute that discriminates against interstate commerce would not be sustained merely because its effects were limited to the state, *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241, 258 (1964); *Camps Newfound/Owatonna, Inc., v. Town of Harrison*, 520 U.S. 564, 573 – 574 (1997), the Court has made clear that when a regulatory scheme does not discriminate against commerce, "there is no reason for [the Court] to step in" when the eco-

nomic burden of the scheme is limited to that state. *United Haulers,* 127 S.Ct. 1786, 1797.

As was true in *United Haulers,* the economic burdens of Kentucky's limited income tax exemption fall entirely within Kentucky. As was the case in *United Haulers,* Kentucky residents have recourse to the political process in Kentucky if they wish to persuade the Kentucky legislature to expand the scope of the income tax exemption to include interest on out-of-state bonds as well as in-state bonds. Furthermore, the political interests of the out-of-state bond issuers are represented in Kentucky, as the economic interests of the Kentucky resident purchasers of those bonds are precisely congruent to the economic interests of the bond issuers.

### B. A State Tax Structure That Favors the State Itself in Providing Government Services Creates Significant Benefits for the State and its Residents.

Not only are there no discernible burdens on interstate commerce as a result of Kentucky's nondiscriminatory financing scheme, but there are several significant benefits to the Commonwealth of Kentucky and to its residents that flow from that scheme.

First, the tax exemption for income derived from the bonds encourages Kentucky residents who benefit from government services provided by the Commonwealth and its subdivisions to purchase bonds to finance the costs of those services. It is clear that "while "revenue generation is not a local interest that can justify *discrimination* against interstate commerce," ... it is a cognizable benefit for purposes of the *Pike* test." *United Haulers,* 127 S. Ct. 1786 1798 (Roberts, C.J.), emphasis in original, citation omitted.

Conversely, there is no justification for requiring Kentucky to subsidize the costs of bond issuance by other states because the services made possible by those bonds do not as a general rule benefit Kentucky residents, including the respondents. If Kentucky were required to subsidize those costs, it would have to recover the costs, either by raising taxes or by reducing the interest paid on its own bonds. Either option would reduce the economic benefits of the bonds to Kentucky, its subdivisions and its residents. That in turn would make Kentucky bonds a less attractive investment to Kentucky residents.

Finally, the state is benefited from the income tax exemption because it reduces the administrative burdens that would accrue if the bonds were subject to tax. If the bonds were taxable, the state would need to raise the interest rate paid on the bonds in order to maintain their investment value. But doing so would needlessly increase the administrative burden of issuing the bonds, with no net benefit either to the state or to resident purchasers of the bonds, because the state would only recover, via taxation, the difference between the higher interest rate paid on taxable bonds and the lower rate on nontaxable bonds.

Kentucky's nondiscriminatory government services financing structure satisfies the *Pike* test as the benefits of that structure clearly outweigh the burdens.

## CONCLUSION

A state tax structure that benefits the state itself relative to other states in the provision of state government services, but treats all private entities alike, does not discriminate against or burden interstate commerce for purposes of the dormant Commerce Clause. There is no rationale for expanding the dormant Commerce Clause beyond the purpose of the

Commerce Clause itself to prohibit differential treatment of state governments in addition to private entities.

Respectfully submitted,

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